

CHAPTER 13

CURTAIL TAX SHELTERS

Current rules limiting the deduction of investment interest are inadequate to curtail tax shelter abuses. This Chapter proposes a comprehensive limitation on the deduction of nonbusiness interest. In addition, the special exceptions to the at-risk limitations for real estate would be repealed, so that the at-risk rules would apply more uniformly to all activities. Finally, the individual and corporate minimum taxes would be revised and expanded.

LIMIT INTEREST DEDUCTIONS

General Explanation

Chapter 13.01

Current Law

In general, interest paid or incurred on indebtedness is fully deductible from income. This general rule is subject to exceptions for interest on indebtedness incurred to generate certain tax-preferred income. Thus, for taxpayers other than certain financial institutions, no deduction is allowed for interest on indebtedness incurred to purchase or carry obligations that generate tax-exempt income. In addition, for noncorporate taxpayers, interest on debt incurred to acquire or carry investment property ("investment interest") is deductible only to the extent of the sum of (i) \$10,000 (\$5,000 for married persons filing separately), (ii) "net investment income," and (iii) certain deductions attributable to net-leased property. Amounts disallowed under this limitation for a taxable year are carried forward and treated as investment interest in the succeeding taxable year.

Interest on debt incurred to acquire or carry personal-use property or business property is ordinarily deductible currently, even if that property does not produce taxable income or is likely to appreciate substantially (resulting in deferred capital gains). (See Ch. 8.01 for a discussion of circumstances in which interest costs must be capitalized when incurred in connection with certain production or manufacturing activities.)

Reasons for Change

Clear reflection of income for tax purposes requires that the costs of generating income be matched with the income actually earned. If a current deduction is allowed for the cost of producing income that is exempt from tax or includable in income on a deferred basis, the current deduction will offset other taxable income and thus eliminate or defer tax. Such "tax arbitrage" occurs, for example, when an investor deducts interest on indebtedness incurred to acquire or carry assets that yield tax-exempt income such as personal-use property or assets held in an Individual Retirement Account. It also occurs, though with less predictability, where indebtedness is incurred to acquire or carry interests in business property that experiences real appreciation over time.

Current law permits taxpayers to deduct the interest costs of generating certain tax-exempt or tax-deferred income. Although interest incurred to acquire or carry tax-exempt bonds is nondeductible, interest incurred to produce analogous forms of tax-preferred income is deductible without limitation. Thus, "consumer interest," i.e., interest incurred to acquire personal

assets, such as a car or vacation home, is fully deductible, even though such assets do not generate taxable income. Similarly, current law limits the deductibility of "investment interest," but interest incurred in a trade or business is fully deductible, even if the investor is not actively engaged in the management of the business and much of the return from the business is expected to be deferred. The current deductibility of interest is an important feature of real estate tax shelter investments structured as limited partnerships.

The unlimited deduction for consumer and "passive" business interest also undermines existing limitations on investment interest and interest incurred to acquire tax-exempt bonds. Since money is fungible, the identification required under current law of the purpose for which indebtedness is incurred is difficult at best. The general deductibility of all consumer and business interest complicates the task of determining whether debt was incurred for a nondeductible purpose.

Proposal

Interest subject to the current investment interest limitation would be expanded to include: (a) all interest not incurred in connection with a trade or business (other than interest on debt secured by the taxpayer's principal residence, to the extent such debt does not exceed the fair market value of the residence), (b) the taxpayer's share of all interest expense of S corporations (other than S corporations in which the taxpayer actively participates in management), and (c) the taxpayer's distributive share of all interest expense of limited partnerships in which the taxpayer is a limited partner. Interest on indebtedness incurred to carry or acquire business rental property used by the taxpayer for personal purposes for part of a taxable year would generally be treated as business interest (and thus not subject to limitation) in the same proportion that the number of days the property is rented at a fair rental bears to the number of days in the taxable year.

Interest subject to the limitation would be deductible only to the extent of the sum of (a) \$5,000 (\$2,500 in the case of a married person filing a separate return), and (b) the taxpayer's net investment income. In general, net investment income for this purpose would have the same meaning as under current law, except that it would include the taxpayer's share of all income of S corporations not managed by the taxpayer and the taxpayer's distributive share of all income of limited partnerships in which the taxpayer is a limited partner. Any interest deduction disallowed for the taxable year under this limitation would be treated as interest expense subject to the limitation for the succeeding taxable year.

Effective Date

Subject to two phase-in rules, the proposal would be effective for interest expense paid or incurred in taxable years beginning on or after January 1, 1986. Under the first phase-in rule, for taxable

years beginning before January 1, 1988, interest subject to limitation would continue to be deductible to the extent of \$10,000 plus net investment income (determined under the new rules). Thereafter, the proposed limitation of \$5,000 plus net investment income would apply. Under the second phase-in rule, for taxable years beginning on or after January 1, 1986, an increasing percentage of interest expense that is treated as investment interest under the expanded definition but that is not subject to the investment interest limitation of current law would become subject to the proposed expanded investment interest limitation. That is, in taxable years beginning in 1986, 10 percent of newly limited investment interest (e.g., consumer interest, interest passed through a limited partnership or a passive subchapter S corporation) would be subject to the limitation; in taxable years beginning in 1987, 20 percent of newly limited investment interest would be subject to the limitation; and in each subsequent taxable year, the percentage would be increased by 10 percentage points until fully phased in. For purposes of the proposed limitation, the expanded definition of net investment income would be phased in on a similar basis.

Analysis

Because the expanded limitation on interest deductions would not apply to mortgage interest deductions on the taxpayer's principal residence or to the first \$5,000 of any additional interest expense, the vast majority of taxpayers would not be affected by the proposal. Interest expenses attributable to a trade or business in which the taxpayer actively participates also would not be subject to the limitation. Thus, sole proprietors, owner-operators of farms, general partners, and shareholder-managers of S corporations would continue to treat their business interest expenses in the same manner as under current law. However, taxpayers with substantial tax shelter interest expense would be prevented, in many cases, from using that interest expense to offset business and employment income.

EXTEND AT-RISK LIMITATION TO REAL ESTATE

General Explanation

Chapter 13.02

Current Law

In general, in the case of individuals and certain closely held corporations, current law limits the loss a taxpayer may deduct from an investment to the amount the taxpayer has at risk with respect to such investment. This "at-risk" limitation on deductible losses is applied on an "activity-by-activity" basis. The at-risk rules extend to all activities conducted by taxpayers to whom the rules apply, other than (1) real estate activities and (2) most business activities actively conducted by closely held corporations. Accordingly, an investor in real estate, a closely held corporation actively conducting a business activity, or a widely held corporation investing in any activity, may generally deduct for tax purposes losses from the investment that exceed the investor's maximum possible economic loss from the investment.

For purposes of the at-risk rules, a taxpayer is generally at risk in an activity to the extent that the taxpayer has contributed money or property (to the extent of its basis) to the activity, or is personally liable to repay borrowed funds used in the activity. A taxpayer is not considered to be at risk with respect to amounts protected against loss through nonrecourse financing, guarantees and stop loss or similar arrangements. Losses which are disallowed for a taxable year under the at risk rules are carried forward indefinitely and are allowed in a succeeding taxable year to the extent that the taxpayer increases the amount at risk in the activity giving rise to the losses.

Reasons for Change

The at-risk rules of current law reflect the fact that, as an economic matter, an investor cannot lose more than the amount that he or she has directly invested plus any additional amount for which the investor is liable. This principle is no less true for investments in real estate or corporate activities than it is for the activities to which the current at-risk rules apply.

However, the purpose of the at-risk rules is generally to restrict the use by individual taxpayers of limited-risk transactions to shelter artificially their income from other sources. The use of limited-risk financing in the public corporate sector has not generally been viewed as abusive. Similarly, the use of limited-risk financing in the closely-held corporate sector has not been viewed as

abusive where loss activities are conducted as substantial active businesses; in such situations, the likelihood that loss activities are utilized for the purpose of sheltering other income of the corporate owners is diminished.

On the other hand, the exclusion of real estate activities from the at-risk rules is not similarly justified. Due to this exclusion, individuals investing in real estate may offset current taxable income from other activities (e.g., wages) with tax losses that will never be matched by economic losses.

The allowance of such noneconomic losses for tax purposes is a necessary basis for many tax-sheltered real estate investments. Front-loaded tax losses that have no economic basis permit the investor to reduce or eliminate tax on his other income. The resulting deferral of tax liability guarantees a return to the investor that may make an otherwise noneconomic investment plausible. Tax-driven noneconomic investment activity diverts capital from more productive uses, causes overinvestment in the tax-preferred activities and thus distorts prices and capital costs throughout the economy.

Tax shelter activity also invites disrespect for the tax law. Whether legally justified or not, the use of tax shelters by high-income, well advised individuals is viewed with confusion and skepticism by ordinary taxpayers. These perceptions undermine the voluntary compliance that is crucial to the income tax system.

Proposal

The at-risk rules would be extended to real estate activities. The at-risk rules would continue to be applicable only to individuals and certain activities of closely held corporations.

Effective Date

The proposal would be effective for losses attributable to property acquired on or after January 1, 1986.

Analysis

Extending the at-risk rules to real estate activities would not inhibit the leveraged acquisition of properties expected to yield a market rate of return. The proposal, however, would require that investors in real estate activities evaluate the economic risk of loss associated with investments in those activities as well as their tax benefits and income potential. The proposal thus would leave real estate investments subject to the same market discipline as currently applies to investments generally. The enhanced neutrality among investment alternatives would improve resource allocation and reduce overinvestment in currently tax-preferred real estate activities. This, in turn, should lead to overall productivity gains.

It is possible that the laws of some States that preclude the use of recourse debt in connection with the acquisition of certain real estate could prevent certain investors in those States from receiving full tax benefits from leveraged real estate investments. It is anticipated that any such States would act quickly to permit business investments in real estate to employ recourse indebtedness.

Some have argued that the proper goal of the at-risk rules is not, as indicated above, to prevent taxpayers from sheltering income with artificial losses, but to police the use of limited-risk financing to inflate artificially value and thus recoverable basis in property acquired by purchase. Under this view, the at-risk rules should be restructured to limit a taxpayer's basis in property financed with limited risk debt. Since the focus of such a rule would be on artificially inflated values, limited-risk financing from unrelated institutional lenders would presumably be free of the basis restriction. Such rule generally would not disturb limited-risk transactions lacking the indicia of abuse, but would limit cost recovery deductions from abusive transactions to a greater extent than current law. Under the Administration proposal, the at-risk rules would continue to serve the broader function of loss limitation that their current structure implies. At the appropriate time, Congress may wish to consider whether the at-risk rules place sensible limitations on artificial losses, or could be targeted instead to restrict abusive transactions.

REVISE ALTERNATIVE MINIMUM TAX FOR NONCORPORATE TAXPAYERS

General Explanation

Chapter 13.03

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" that may increase their overall tax liabilities. For noncorporate taxpayers, such minimum taxes are imposed in the form of an "alternative minimum tax" ("AMT").

Noncorporate taxpayers whose regular tax liabilities are substantially reduced by tax preferences are, in effect, subject to the AMT in lieu of the regular income tax. The AMT is equal to 20 percent of the excess of the taxpayer's "alternative minimum taxable income" ("AMTI") over an exemption amount.*/ A taxpayer's AMTI is computed by (a) adding tax preferences back to adjusted gross income, (b) subtracting the "alternative tax itemized deductions," and (c) making adjustments for net operating loss carryovers and certain trust distributions included in income under the so-called "throwback rules." The alternative tax itemized deductions include (a) casualty losses and certain wagering losses, (b) charitable contributions, (c) deductible medical expenses, (d) certain interest expenses (including interest on debt incurred to acquire the taxpayer's principal residence), and (e) estate taxes attributable to income in respect of a decedent. The exemption amount for the AMT is (a) \$40,000 for a joint return or a surviving spouse, (b) \$30,000 for a single taxpayer or head of household, and (c) \$20,000 for other noncorporate taxpayers.

Items of tax preference generally include:

- (a) Dividends excluded from gross income.
- (b) The excess of accelerated over straight-line depreciation for each item of real property and leased personal property (other than recovery property).

*/ The statutory term "alternative minimum tax" actually refers to the excess of (1) 20% of AMTI less the exemption amount over (2) the regular income tax. This excess is imposed in addition to the regular tax. For convenience, however, the terms "alternative minimum tax" and "AMT", as used herein, will refer to the sum of the true alternative minimum tax and the regular income tax.

- (c) In the case of an item of recovery property (but only if it is leased property, 18-year real property, or low-income housing), the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated under the straight-line method over prescribed recovery periods.
- (d) The net capital gain deduction.
- (e) The excess of amortization deductions for each pollution control facility over depreciation deductions that would otherwise be allowable for the facility in the absence of special amortization.
- (f) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.
- (g) In the case of intangible drilling and development costs of oil, gas, and geothermal properties, the amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties.
- (h) The excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a three-year period.
- (i) In the case of circulation expenditures, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a three-year period.
- (j) With respect to each depletable property, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.
- (k) In the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value of the stock over the option price.

Reasons For Change

The alternative and corporate minimum taxes were originally enacted as part of the Tax Reform Act of 1969 to ensure that "all taxpayers are required to pay significant amounts of tax on their economic income." The measures (originally a single minimum tax for all taxpayers) were considered necessary because, as concluded by

Congress, "many individuals and corporations did not pay tax on a substantial part of their economic income as a result of the receipt of various kinds of tax-favored income or special deductions."

Since the Administration proposals contain incentive provisions that depart from the measurement of economic income, some high-income individuals would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income individuals paying little or no tax threatens public confidence in the system. Consequently, a minimum tax designed to limit the number of high-income low-tax returns should be retained.

Proposal

Under the proposal, the minimum tax for noncorporate taxpayers would continue to be structured as an alternative tax, with a rate of 20 percent. Alternative minimum taxable income would be computed by adding to adjusted gross income the excess of preference items over \$10,000 (\$5,000 for married persons filing separately), and subtracting (a) allowable itemized deductions, (b) personal exemptions, and (c) a threshold exemption amount. The threshold exemption amount would be \$15,000 for joint returns (\$7,500 for married persons filing separately), \$12,000 for heads of households, and \$10,000 for single persons.

Allowable itemized deductions generally would include all itemized deductions, with the exception of the deduction for non-business interest (other than mortgage interest with respect to the taxpayer's principal residence) in excess of net investment income.

Items of tax preference subject to the alternative minimum tax would include the following:

- (a) The tax preference, as defined under current law, with respect to each item of real property placed in service before 1981 and each item of recovery property which is 15-year real property, 18-year real property, or low-income housing.
- (b) For each item of real property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

- (c) The tax preference, as defined under current law, with respect to each item of leased personal property placed in service before 1981 and each item of leased recovery property which is not 15-year real property, 18-year real property, or low-income housing.
- (d) For each item of leased personal property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.
- (e) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction that would otherwise be allowable in the absence of special amortization.
- (f) The net capital gain deduction.
- (g) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.
- (h) In the case of intangible drilling and development costs of oil, gas, and geothermal properties (other than dry holes), eight percent of the amount of such costs paid or incurred in the taxable year.
- (i) With respect to each depletable property placed in service before January 1, 1986, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.
- (j) With respect to each depletable property placed in service on or after January 1, 1986, the excess of the deduction allowable for the taxable year for percentage depletion over the amount that would have been allowable for the taxable year had capitalized costs been recovered through cost depletion.
- (k) With respect to each item of contributed property for which a charitable contribution deduction is allowed, the excess of the deduction allowed over the donor's basis in the property.

- (l) The excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a ten-year period.
- (m) In the case of stock transferred pursuant to the exercise of an incentive stock option, the excess of the fair market value of the stock over the option price.

The deduction for circulation expenditures would not be treated as an item of tax preference under the proposal.

Effective Date

The revised alternative minimum tax would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would minimize the number of high-income individuals who pay little or no tax as a result of heavy utilization of the tax preferences included in the alternative minimum tax base, and would thus improve the fairness of the tax system. Due to the exclusion of a taxpayer's first \$10,000 of preferences from alternative minimum taxable income, only individuals using substantial amounts of tax preferences would need to compute the minimum tax. The threshold amounts would ensure that no individual would be subject to a minimum tax liability greater than the regular tax liability computed by adding preferences to the regular tax base. For analysis of the treatment of IDCs as an item of tax preference, see Ch. 9.03.

REVISE CORPORATE MINIMUM TAX

General Explanation

Chapter 13.04

Current Law

Taxpayers whose taxable incomes are substantially reduced by specified "items of tax preference" are subject to "minimum taxes" which may increase their overall tax liabilities. For corporations, a minimum tax is imposed in the form of an "add-on" minimum tax.

In general, the corporate minimum tax is equal to 15 percent of the amount by which the taxpayer's items of tax preference exceed the greater of (a) \$10,000 or (b) the regular corporate income tax for the taxable year (without regard to the accumulated earnings tax or personal holding company tax, if any, and reduced by most allowable tax credits).

Items of tax preference generally include:

- (a) The excess of accelerated over straight-line depreciation for each item of real property (other than recovery property) and, for personal holding companies, each item of leased personal property (other than recovery property).
- (b) In the case of each item of recovery property that is 18-year real property or low-income housing (and, for personal holding companies, each item of leased recovery property other than 18-year real property or low-income housing), the excess of ACRS deductions over depreciation deductions that would have been allowed had the property been depreciated under the straight-line method over prescribed recovery periods.
- (c) The amount of income effectively untaxed due to the preferential rate of tax applied to capital gains.
- (d) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction that would otherwise be allowable in the absence of special amortization.
- (e) In the case of mining exploration and development costs with respect to a mine or other natural deposit of a personal holding company, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.
- (f) In the case of intangible drilling and development costs of oil, gas, and geothermal properties of personal holding companies, the

amount by which (i) the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period, exceeds (ii) the taxpayer's net income from oil, gas, and geothermal properties.

- (g) In the case of circulation expenditures of personal holding companies, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a three-year period.
- (h) In the case of research and experimental expenditures of personal holding companies, the excess of the amount allowable as a deduction over the amount that would have been allowable had such expenditures been amortized over a ten-year period.
- (i) The excess of a financial institution's allowable deduction for bad debt reserves over the deduction that would have been allowable had the institution maintained its reserves on the basis of actual experience.
- (j) With respect to each depletable property, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.

Reasons For Change

Since the Administration's tax reform proposals contain incentive provisions that depart from the measurement of economic income, some high-income corporations would be able to eliminate their tax liabilities or substantially reduce their effective tax rates by heavy utilization of such provisions. As under current law, the prospect of high-income corporations paying little or no tax threatens public confidence in the tax system. Consequently, a minimum tax designed to limit the number of high-income, low-tax returns should be retained.

The add-on corporate minimum tax under current law is poorly designed for this purpose. The add-on tax may be imposed on preferences used by a corporate taxpayer even though the taxpayer is taxed at an effective rate higher than the minimum tax rate. An "alternative" minimum tax, imposed only to the extent a taxpayer's regular effective tax rate falls below a minimum acceptable level, is better designed to achieve the purposes of a minimum tax.

However, an alternative minimum tax limited to the tax preferences applicable to corporations under current law would be insufficient to prevent many corporations from eliminating their regular tax on economic income. Additional preferences should thus be taken into account. Although the Administration proposals generally would allow accelerated depreciation as an incentive for capital formation, a debt-financed acquisition of depreciable assets may reduce the effective tax rate on such investment substantially below the effective tax rate on similar investments that are equity financed.

The full deductibility of interest, without adjustment for the extent to which interest payments are compensation for the effects of inflation rather than a cost of borrowing money, results in significant mismeasurement of income. This mismeasurement is more serious where the investment itself receives preferential treatment. Since the low effective tax rates for debt-financed investment in depreciable property are unnecessary to encourage capital formation, the minimum tax should apply to corporations that substantially reduce their regular tax liabilities through such debt-financed investments.

In addition, corporations engaged in oil and gas activities may eliminate or substantially reduce tax liabilities through excessive use of the election to expense intangible drilling costs ("IDCs"). Although the election to expense IDCs is provided as an incentive for domestic energy production, the value of the incentive is appropriately an item of tax preference for purposes of the corporate minimum tax.

Proposal

Under the proposal, the minimum tax for corporations would be repealed and replaced with an alternative minimum tax, similar in structure to the alternative minimum tax for noncorporate taxpayers. The alternative minimum tax rate would be 20 percent. Alternative minimum taxable income would generally be computed by adding to taxable income (or loss) the excess of preference items over \$10,000, subtracting a threshold exemption amount of \$15,000, and making adjustments for net operating loss carryovers attributable to preference items. The foreign tax credit generally would be allowed to offset minimum tax liability.

Items of tax preference subject to the alternative minimum tax would include the following:

- (a) The tax preferences, as defined under current law, with respect to each item of real property placed in service before 1981 and each item of recovery property which is 15-year real property, 18-year real property, or low-income housing.
- (b) For each item of real property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.
- (c) In the case of personal holding companies, the tax preference, as defined under current law, with respect to each item of leased

personal property placed in service before 1981 and each item of leased recovery property which is not 15-year real property, 18-year real property, or low-income housing.

- (d) In the case of personal holding companies, for each item of leased personal property placed in service on or after January 1, 1986, the amount (if any) by which the deduction allowed under CCRS for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.
- (e) The excess of the allowable amortization deduction for each pollution control facility over the depreciation deduction for that facility that would otherwise be allowable in the absence of special amortization.
- (f) The amount of income effectively untaxed due to the preferential rate of tax applied to capital gains.
- (g) In the case of mining exploration and development costs with respect to a mine or other natural deposit, the excess of the amount allowable as a deduction over the amount that would have been allowable had such costs been amortized over a ten-year period.
- (h) In the case of intangible drilling and development costs of oil, gas, and geothermal properties (other than dry holes), eight percent of the amount of such costs paid or incurred in the taxable year.
- (i) With respect to each depletable property placed in service before January 1, 1986, the excess of the deduction for depletion for the taxable year over the adjusted basis of the property.
- (j) With respect to each depletable property placed in service on or after January 1, 1986, the excess of the deduction allowable for the taxable year for percentage depletion over the amount that would have been allowable for the taxable year had capitalized costs been recovered through cost depletion.
- (k) With respect to each item of contributed property for which a charitable contribution deduction is allowed, the excess of the deduction allowed over the donor's basis in the property.
- (l) Twenty-five percent of the deduction for interest expense for the taxable year (reduced by taxable interest income for such year), but not in excess of the amount (if any) by which the deduction allowed under CCRS for the taxable year for each item of personal property placed in service on or after January 1, 1986 (but, in

the case of personal holding companies, only if such property is not subject to a lease), exceeds the deduction which would have been allowable for the taxable year had the property been depreciated along the lines of the real economic depreciation system proposed in the Treasury Department's Report to the President, Tax Reform for Fairness, Simplicity, and Economic Growth, published in November 1984.

- (m) In the case of personal holding companies, the excess of the deduction for the taxable year for research and experimental expenditures over the amount that would have been allowed had such expenditures been amortized over a ten-year period.

The deduction for circulation expenditures would not be treated as an item of tax preference under the proposal.

Effective Date

The proposed alternative minimum tax would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would minimize the number of high-income corporations paying little or no tax as a result of heavy utilization of the tax preferences included in the alternative minimum tax base, and would thus improve the fairness of the tax system. Due to the exclusion of a corporation's first \$10,000 of preferences from alternative minimum taxable income, corporations using only small amounts of tax preferences would not need to compute the minimum tax. The \$15,000 threshold amount would ensure that no corporation would be subject to a minimum tax liability greater than the regular tax liability computed by adding preferences to the regular tax base.

The inclusion of 25 percent of net interest expense as an item of tax preference (to the extent of the excess of CCRS deductions for personal property over economic depreciation) effectively treats the taxpayer's first investments in CCRS property as being financed by indebtedness of the taxpayer. The 25 percent fraction is intended to identify, on the basis of very conservative assumptions, the portion of such interest representing an inflation premium rather than a cost of borrowing money. For analysis of the treatment of IDCs as an item of tax preference, see Ch. 9.03.